The Bit Commons response to Ofcom VULA Margin consultation.

Thank you for the opportunity to reply to the VULA Margin consultation. It is a very important but very difficult topic. In responding to the questions the author have drawn upon contributions made to the UK's Broadband Plan, experience on BDUK's rural programme and latterly assisting SME customers gaining access to FTTP services. The author also draws on a 22 year career with BT much of it running competitive marketing programmes. The Bit Commons principle motivation in responding is to contribute to the objective of 'best in Europe' including any possible contribution to ensure the £1.6bn of public monies meant for rural NGA networks is spent effectively in rural areas.

The VULA Margin proposal is a good conceptual invention, but the measure carries a high risk of not meeting the retail competition objectives set. This response outlines some additional measures in addition to the VULA Margin proposal that might assist Ofcom in meeting its objectives. I have also made some comments on the measure itself . I have completed this response early and copied to a number of other potential respondents in the hope that the ideas can be developed and improved by others before the final submission date in August.

The Talk Talk margin squeeze test was dismissed on the basis there was no grounds for such a claim. This suggests there is a good state of health on the current BT WLA and BT Retail margins. The VULA margin proposal looks to be creating conditions such that Talk Talk and SKy get a period of time to catch up on BT Retail's early success in marketing FTTC. I hope elements of this response helps to increase the probability of Ofcom meetings its objectives while supporting the Government goal of being 'best in Europe'.

It is unclear whether it is expected that the VULA margin will work just within the £2-50-£3-50 range identified or whether it can be expected to work at much higher levels. I have attempted to outline a case where BT invests a significant amount in the next round of Premiership broadcast rights which would be accompanied by a big forecast in new BT Broadband customers. It is unclear that the VULA margin would meet it's objectives in these circumstances.

Q2.1 Do you consider that there has been a material change in circumstances in the WLA market since the 2014 FAMR Statement? Please provide supporting evidence as necessary.

Significant material changes have occurred during the time of the review and may impact upon the success of the VULA margin proposal.

Several bits of information have emerged about the low cost (c£1.3bn capital (capitalised labour and cash) as opposed to £2.5bn used by BT public policy teams) of the BT NGA commercial roll out. When taken alongside the scale of public cash investment (£1.2bn+£450m) and BT's recent decision to treat FTTP access as a premium service this might give Ofcom some licence to review the WLA price should the VULA Margin proposal not prove effective. At a minimum, Ofcom could seek some corresponding understanding as to the level of network investment if BT has the freedom to set wholesale prices. Furthermore Ofcom's desire to avoid tampering with the WLA price could be reviewed given BT's recent history in misleading Parliament on the level of matched capital funding for the rural NGA project and the very significant reduction in the capital required to roll out NGA (FTTC) in commercial areas. The consequences of these events and there consequences will be felt throughout this review period and will impact on the probability of the VULA margin proposal being effective.   Ofcom could retain some right to review the WLA price should circumstances demand it.

Vodafone did raise the matter (Ofcom Vol 1, Fixed Access Market reviews, chapter 12 ,P12.130) of BT capital expenditure not changing before NGA investment and the period of NGA investment. Ofcom rejected this argument on the basis of the commitments it made to BT and the uncertainty of take-up going forward. Commitments go both ways. If Ofcom have been misled, and BT's evidence has not convinced the National Audit Office or the Public Accounts Committee of its costs or investment levels then Ofcom could give itself some additional discretion to act within the review period.

The Bit Commons believes the pricing freedom on the wholesale price should come with a requirement to invest a proportion of revenues to improve the fibre access network so all customers can gain access to an NGA service. Ofcom could also seek additional assurances that the likely £1.6bn of public cash funding and matched BT capital funding in whatever form it takes is suitably ring fenced so there is no opportunity for any of these monies to directly or indirectly impact other markets, such as investments in football rights. Although the management of the public funding is the responsibility of the BDUK state aid competency centre, it is important given the timing of the BDUK Framework prices, one month before the 2012 Olympics, and the need to deliver a political ambition within the life of one Parliament that additional scrutiny is brought to bear on these funds. This suggestion is consistent with the concerns expressed by the National Audit Office and the two Public Account Committee hearings and reports made so far.

Q3.1 Do you agree with our proposed regulatory objective for the VULA margin? Please provide reasons in support of your view.

Ofcom's objective for the VULA margin is understood, but the measure itself looks unlikely to meet the objectives if it is to function on its own.

The Ofcom proposal of a single fix, a magic bullet if that's an appropriate shorthand, looks to have a high risk of failing to meet all that is expected of it. The goals of 1) enhancing competition in superfast broadband, 2) protecting investment incentives when the major investment is public subsidy in the review period, 3) creating innovation and 4) preventing distortion of the WLA market. The measure does not appear to deal with the fundamental changes in the market but would act to temper BT power and if successful will allow Sky and Talk Talk to do some catch up in terms of market share for FTTC services. However there would appear to be too many ways to undermine and challenge a VULA margin working as a standalone measure.

The overall analysis appears to underplay several crucial factors. BT Retail could and did switch to superfast customer recruitment more quickly. As a separate accounting entity they did not have to consider LLU depreciation. At a BT group level this would have been the case, but at a BT Retail level the LLU depreciation does not impact BT Retail margins, so they could and did get an early mover advantage over those directly managing LLU investments. Ofcom could be underestimating the changes in business models when moving from a business model using exchange based LLU assets, to one where involving virtual control of features on a line card in a BT street cabinet, requiring LLU assets and investments to be written off earlier than expected.

Ofcom should also take account of the additional uplift and boost BT Retail will receive from the publicly funded rollout of NGA in rural areas as it is being done under the BT banner and will bring some 5m additional homes within reach of a FTTC cabinet in the review period.

Ofcom's action to mediate the potential impact of BT's entry into sport on the superfast broadband market is unclear. The question is whether the measure can ever be enough if BT decides to tackle Sky's dominance in the pay TV market in this period. Adding a 'few pounds' to BT Retail price may come unstuck if the measure as outlined results in far more than a 'few pounds' following the next round of sports rights auctions. News International is needing to deal with the consequences of the hacking scandals and I cannot see BT ignoring the opportunity to build its sports business at this time. The VULA margin proposal will come under significant pressure if the impact turns out to be anymore than a few pounds. In the circumstances where BT make a determined effort to develop its sports business, BT is likely to use its discretion to re-allocate common costs and its ability to re-state costs to maintain its current position if it needs to do so. Perhaps it would be pragmatic to develop a plan B, where plan B includes an action where BT's investment in sport does not result in a reduction in investment in the network.

It may be the case that Ofcom's plan B for this measure would be simply more of plan A which if it becomes more than a few pounds would become unacceptable to end users. Furthermore some analysis ought to be done as to whether VULA margin proposal would work modelling a big investment by BT in the next premier league auctions. The latter could be mitigated by a very large increase in total NGA broadband customers over which the costs are recovered. I would suggest a significant investment by BT into sport, (100 premier games a year '£7m to £10m each) ought to be modelled using a generous forecast to check whether the VULA proposal and its objectives would still hold. The working of the proposal could be down to how flexible Ofcom and industry would be in accepting the forecasts made and the consequences of the forecast being over or under forecast. I believe this possible scenario may make VULA proposal ineffective and thus some additional mitigation measures are needed.

The following is a further mitigation measure but it is undeveloped and needs more work. The lower than expected investment costs for FTTC (£1.3bn capital as opposed to £2.5bn) and good early take up rates do suggest that industry and the regulator have been over conservative on costs and under-estimated the demand and need. Perhaps rather than stopping at FTTC and waiting for second cabinets to be installed, Ofcom's objectives for competition could be supported by a more determined effort in readying PIA products for a pro-competitive FTTP programme driven by SKY and Talk Talk. LLU has been leapfrogged by SLU but as cabinets fill, demand for FTTP will rise and could compete with FTTC, particularly as the cost of adding one additional customer to a new additional cabinet is likely to exceed that of adding one additional customer through FTTP. Ofcom have acknowledged in this report that costs of the CGA and NGA broadband packages are similar. If it was acknowledged BT has had a two year head start on FTTC, and BT has repositioned FTTP as a product for businesses, then there is room for Talk Talk and Sky to make their case to commit to a FTTP programme. This is a significant shift in policy but I think it is needed and could play some part in keeping the focus on securing and sustaining the 'best in Europe' goals. This could be facilitated by new access measures where the higher level of public funding has played a greater than expected role in securing NGA upgrades. It would assist in supporting the VULA margin proposal. By being within a package of measures and policies it increases the probability of the success of the VULA margin proposal. It is not too late to influence how the remaining £450m of public expenditure for rural is spent.

Q4.1 Do you agree with the proposed form of the VULA margin requirement and associated compliance monitoring? Please provide reasons in support of your views.

Ofcom have done a great piece of conceptual work but for reasons outlined the measure has a high risk of not meeting the objectives set for the review period.

The Bit Commons has outlined some measures that could increase the likelihood of success of the VULA margin proposal. On its own it looks vulnerable to costings being routinely challenged or amended.

The Bit Commons suggested Ofcom check the working of this proposal should BT invest heavily in the next Premier League rights auctions and where this is underwritten by a large increase in the forecast for total NGA customers. Forecasting one off events like the impact of a new Premier league season suggests the VULA margin proposal could be rendered ineffective in terms of its competition goals. This is not something which is easy to predict or indeed deal with the consequences if such an event occurs.

Q5.1 Do you agree with our approach to the VULA margin assessment? In particular, do you agree that we should:

(a) adopt an adjusted EEO approach?

(b) assess costs on a LRIC+ basis?

(c) assess costs and revenues at the level of the entire portfolio of superfast broadband packages marketed at residential consumers and taking into account the components of these packages?

Please provide reasons in support of your view.

The rationale and logic looks sound, but using this to achieve the objective set is problematic.

Using the entire superfast portfolio where the cost of BT TV is being used in a VULA margin calculation for customers who do not wish to consume sport seems unjust if the measure ends up being more than the £2.50-£3.50 outlined.

The decision on the level of common costs applied and whether these were newly applied common costs or re-allocated from other inputs may create problems on implementation. I have not seen a proposal on how you stop BT re-stating its costs when re-stating of costs occur routinely in the regulated accounts.

Q6.1 Do you agree with the details of how we propose to treat costs and revenues? In particular, do you agree:

(a) with our draft guidance, particularly the proposed guidance in relation to BT Sport?

(b) with the adjustment to average customer lifetimes in the proposed SMP condition?

(c) with the floor on unit bandwidth costs in the proposed SMP condition? (d) that overall our proposals are likely to meet our objective?

Please provide reasons in support of your view.

The guidance on BT Sport needs to be tested using an event like a significant increase in investment by BT with a corresponding increase in forecasted take-up. A big investment where a big forecast is accepted is likely to reduce the impact of the VULA margin proposal.

Given this is conceptualised solution then some of the costing's (b) could be included or excluded as Ofcom learned more about the operation of the scheme. If (b) increases the VULA margin to more than the '£2-50- £3.50' then it could be removed. The bounds of the intended impact of the VULA margin model are not outlined so it is not clear as to what the intended limits might be. The conceptual model needs to be tested should such bounds be broken.

The use of more than the most efficient unit bandwidth costs (c) does look peculiar. The quality of the users peak hour experience is directly related to the amount of bandwidth available in the peak hour. If the VULA margin proposal effectively imposes a price increase and the unit bandwidth cost is used, perhaps BT should be allowed the option to amend its planning rules and provision more bandwidth per customer. The Bit Commons preferred position is to use the lowest cost of bandwidth and not consider in this case what Sky or Talk Talk might wish it to be. The user experience needs to be protected and including this measure might adversely impact how packages are planned and provisioned during this period.

Summary

The VULA margin proposal if confined to a £2-50-£3-50 increase in BT monthly rental could meet Ofcoms objectives but on its own the proposal looks vulnerable. The Bit Commons suggests;

a) A possible ring fencing of BT network investment for 2014-2017 and measures to improve accounting of the public investment of some £1.6bn capital taking place in that period.
b) Ofcom to allow itself some flexibility on the wholesale price of WLA given (a) above and the reduction in capital needed for the commercial rollout of NGA. BT's tendancy to mis-lead Government & Parliament on the scale of NGA investment, its costs and the level of matched funding for the rural programme suggests Ofcom could and perhaps needs to keep any options it has open.
c) Ofcom to perhaps encourage Talk Talk and Sky to declare their ambitions for FTTP aided by improved PIA products and challenge for the remaining £450m public funded targeted at rural areas which include urbanised areas in large county towns.
d) The Bit Commons suggests Ofcom test the VULA margin proposal assuming a scenario where a significant investment by BT in Premier league football supported by a significant increase in forecasted numbers.

e) Use the lowest possible unit bandwidth costs given the potential negative impact on the users experience. Unit Bandwidth costs are also used as a measure in some best in class measures and thus using higher costs may be reported wrongly.

The Bit Commons believes these minor modifications are consistent the mix of responsibilities Ofcom outlines in section 3.37 of the consultation document and is proportionate and justified given the existing dynamic in the current market place, a dynamic which will be reinforced by BT’s control of the publicly subsidised rural NGA programme.

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